Tools for Controlling Inflation: Pros and Cons

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While Lithuania debates the issue of the euro, all seem to forget that launching the euro is not a goal in itself. It's a tool that must help achieve the most signal goal. This goal is to ensure Lithuania's long-term economic development, sustainability and competitiveness. No doubt, the introduction of the euro would present specific advantages, such as an easier trade with the euro-zone countries, lower costs of exchanging currency, investors' potentially stronger confidence in the Lithuanian business climate and the like. However, both the introduction of the euro itself and measures intended to facilitate it may well exert both positive and negative effects that should not be overlooked.

In its Medium-Term Strategy for Price Stability, the Lithuanian Government has envisaged measures and proposals for the introduction of the euro in the country. The aim of these measures is to control inflation, in other words, to curb the growth of inflation (it's no news that this one indicator of the level of inflation precluded Lithuania from launching the euro starting from the year 2007).

Some of these measures and proposals are surely welcome. The projected measures would be beneficial not just with respect to the euro launch - they would also help build a better and more sustainable economic environment in the country. To put it in other words, these measure ought to be implemented one way or other, even if the euro didn't exist at all. These are the proposals to conduct a stricter fiscal policy and to balance the national budget. Lithuania has continuously failed to eliminate the budget deficit, and its state debt remains the largest among the Baltic countries. Rapidly increasing government spending provokes the formation of unjustified expectations, menaces the country with economic "overheating" and drives the level of inflation upwards.

Some argue that Lithuania's state debt is rather acceptable and perhaps even too small as government indebtedness (the debt of the public sector accounts for less than 20 percent of GDP) is markedly smaller than that required by the Maastricht criterion (60 percent of GDP) and the state debts of most old European member states. But this argumentation is ungrounded. First, it should be kept in mind that Lithuania did not inherit any debts after the collapse of the Soviet Union – all its debts mounted during the years of its independence. Thus, Lithuania ought to be compared with other countries of the Soviet Block, rather than Western European countries. Second, the Maastricht criterion sets the maximal level of the state debt. The fact alone that Lithuania's state debt satisfies the Maastricht criterion is no reason to maintain that the load of the state debt is acceptable. If "4" points is a satisfactory mark, and the pupil is given "6" points during examination, this doesn't imply that he/she must not strive for better evaluation.

Yet, other projected tools cause some doubts. For instance, the proposal to halt a more rapid reduction of the personal income tax (PIT). The arguments are as follows: a more rapid reduction of PIT would stimulate borrowing, consumption and spending. This would result in increased consumption on the domestic market, thus pushing up the level of inflation. However, this argumentation misses two important points. First, this particular rapid growth of internal consumption is one of the factors behind an especially speedy rise of wages and salaries. The growth of earnings is now outpacing that of productivity, which is a serious threat to local business' competitiveness. A lower rate of PIT would render more opportunities to companies to attract workers for the same amount of money. Another aspect should be also taken into account – the taxpayer money, collected to the budget, is "released" back to the economy, that's why it also "heats" the economy and moves the level of inflation and its indicator upwards.

The Strategy for Price Stability also anticipates some other instruments that could be a help for cutting the size of the indicator of inflation but they would basically prove short-term steps that might exert negative influence on the Lithuanian economy in the long run. First and foremost, it’s a proposal to **restrict the growth of wages and salaries (it should be noted that with the help of** administrative means the growth of wages and salaries can be restricted only in the public sector). It’s not spiny to foresee the would-be consequences of this move: eventually, workers of the government sector (the best ones in the first place) would shift to the private sector or go to work abroad. Proposals to mark down regulated prices could be treated similarly. If, by way of regulation, prices were fixed too low, this would diminish incentives to invest, the quality of services would slump or they would not be offered at all. In general, prices should not be considered as “low” or “high” – prices must reflect the information of the market (i.e. they should not be regulated).

Doubts also revolve around the proposal to implement “an optimal plan of excise duties”, or to raise excise duties earlier than the country possibly can. This step has been tailored for prompting a “wave” of inflation earlier which would abate at the time when Lithuania’s indicators are evaluated according to the Maastricht criteria. **It is acknowledged in the Strategy for Price Stability that a more rapid increase in excise duties on tobacco products (the current plan is a 30-percent increase per year) may cause a complete disbalance of the domestic market and activate smuggling activities in particular. Therefore, the Strategy does not contain a recommendation to raise excise duties on tobacco earlier. On the other hand, the Strategy for Price Stability includes a recommendation to conduct an earlier increase in excise duties on fuel. It should be highlighted that this step would engender similar effects: smuggling activities and illegal sales of fuel would intensify, thus harming consumers and legally operating companies. So it’s highly questionable whether it is worth to miss the chance to take advantage of the allowed transitional periods, while deliberately carrying out increases in excise**

duties earlier. In addition, this may serve as an argument to trigger off citizens' negative outlooks on the euro.

Several measures have not been included in the **Strategy for Price Stability** which would both help cutting inflation and be instrumental in improving the country's general economic situation. Land market liberalisation should be mentioned in the first place. At present, **the existing complex land market regulation insupportably reduces the supply of real estate – so it naturally leads to soaring prices of real estate. Another important measure is fostering a general growth of competitiveness. The more competitive the market, the stronger the pressure for prices to go down. It should be also added that namely natural competition among businesses would serve as the prime factor to arrest the "unjustified" growth of prices during the launch of the euro and would also shield consumers' interests.**

Tax favours for housing loans, perverting people's motivation, could be scrapped as well. This move might retard the growth of the loan portfolio – it would lessen the pressure for real estate prices to tend upwards. Finally, subsidising consumption of energy resources ought to be eliminated as well, integrating these subsidies into one general social assistance benefit. The present situation doesn't encourage people to use energy resources efficiently. Large expenses on heating services determine their relatively big weight in the basket of consumer goods and services, for this reason, soaring prices of energy resources on the global market has a more considerable impact on the level of inflation in Lithuania, compared to other countries.

In conclusion, accurate projections of changes in the level of inflation are unfeasible due to a number of factors. Granted that all measures put forth in the Strategy for Price Stability are implemented, we still cannot be sure that Lithuania will satisfy the Maastricht criterion in the end. Besides, various artificial manipulations in prices may come to serve as a pretext for the European

Commission to treat Lithuania's indicator of inflation as "unsustainable." So wouldn't it be expedient to give effect to those instruments that would be beneficial not just with regard to trimming inflation and launching the euro, but that would also provide aid in streamlining Lithuania's competitiveness and aggrandise welfare? In a nutshell, pursuing a strict fiscal policy, eliminating the budget deficit, scrapping various subsidies and tax favours that distort the market, launching liberalisation reforms and increasing the overall competitiveness are among those important tools.

Vytautas Kuokštis, Policy Analyst, LFMI